UNIT 13 MULTINATIONAL AND EXPORT ORGANISATIONS

Objectives

After studying this unit you would be able to understand the:

- differences across countries and its impact on MNC's operations;
- the transfer pricing process of MNC's and it's affiliates;
- exchange rate mechanism and different exposures related to it; and
- control system design issues.

Structure

13.1 Introduction

13.2 Definition of Multinational Corporation

13 .3 Differences Across Countries

13.4 Transfer Pricing

13.4.1 Transfer Pricing for an affiliate's of a MNC

13.5 Exchange Rate and Management Control

13.5.1 Different types of Exchange Rate Exposure

13.6 Control System Design Issue

13.7 Special Control Issues in MNC's

13.8 Summary

13.9 Self Assessment Questions

13.10 Further Readings

13.1 INTRODUCTION

During the past two and a half decade there has been a rapid internationalisation of business which has led to changes in the organisational structure and has given rise to additional issues. The additional issues involved are control of foreign affiliates, adjustment to the control process, exchange rates and transfer pricing. This unit also attempts to make you sensitive towards differences across countries, which has an impact on business process. These differences act as catalyst for innovations in the management process.

13.2 DEFINITION OF MULTINATIONAL CORPORATION

In the context of international business we hear words like global corporations, international corporations and multinational corporations. While in general these terms may be interchangeably used, there are actually subtle differences between them. Within these differences global and multinational corporations represent two extremes and international .corporations fall somewhere between these two. In a global corporation production facilities are generally centralised, and located in one or a few countries to get the advantage of

economy of scale and cost. The products are exported from these countries to the others depending on demand. On the other hand in a multinational corporation, production facilities are generally located separately in each country and each country's operations are organised almost totally independently. However, within such independence, there is always a need for integrating the-operations of local subsidiaries with a view to achieve overall optimality for the parent company. This optimality may be in terms of economy, monetary repatriations, growth, surplus, etc.

Whether an international company shall move towards becoming a global company or towards multinational company will depend on the strengths of global pull factors or regional pull factors. If the global pull factors are stronger, the company will tend to become a global company. On the other hand if regional pull factors are stronger the company will become a multinational company. Some of the global pull factors and regional pull factors are given below:

Global Pull Factors	Regional Pull Factors
Strong comparative advantage Production Very high volume requirement for achieving cost competitiveness	Strong restrictions in movement of raw materials Strong regulatory barriers to export and import

When conditions are such that global pull factors are weak and regional pull factors are strong, the situation can be ideal for organising the company on multinational basis. Similarly when global pull factors are strong and regional pull factors are weak, the situation is ripe for organising it as a global corporation.

Activity 1

List the name of five companies which are subsidiaries of multinational companies. Also try to find out the percentage equity holding of the parent company in the subsidiary.

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13.3 DIFFERENCES ACROSS COUNTRIES

As all dimensions of business operations are becoming global managers need to be aware of national difference In order to make an impact of management practices for the purpose they are designed for, managers must understand how they must adapt their management practices to make them work in international locations. Adapting management and control practices across various countries is complicated process. There are primarily three sets of factors which have affect on control system choices

across countries in systematic manner. These factors are :

a) National culture
b) Institutions
c) Local environments

Managers of multinational organisations must adapt their control practices to the set of unique factors faced' in each of the operating country and also prepare for the potential differences in responses of the employees. Let us now discuss each of these unique factors in detail:

a), Cultural differences across countries

Greet Hafstede defined national culture as "the collective programming of the mind which distinguishes the members of one group or society from another." With reference to management control, people of different national origin will have different preferences for and reactions to management control.

National culture differences has a great deal of bearing on Management Control Systems because control problems are behavioral problems,

The four cultural dimensions as identified in a major study by Greet Hofstede are :

a) Individualism

b) Power distance

c) Uncertainty avoidance

d) Masculinity

Each of these aspects has an implication far management control as well as on other facets of an organisation.

The *individualism* dimension of national culture relates to individuals self concept that is in a group, what are the concerns of an individual wether it is I or We.

Individuals from individualistic cultures places more emphasis on individual achievement rather than group achievement and believe in interpersonal conflict resolution rather than conflict suppression whereas individuals from collectivism culture lays more emphasis on group's goal achievement and interpersonal harmony.

The *power distance* dimension relates to the degree of the acceptance of unequal distribution of institutional power among the employees.

Uncertainty avoidance dimension relates to the outcome of present action in future. When the results of present action are unknown that gives rise to uncertainty.

The *masculinity* dimension relates to the preference for achievement, assertiveness and material success as opposed to emphasis on relationship, modesty and quality of life.

Each of the above four dimensions has implication for management control. The countries where employees are high on individualism would prefer individual oriented rather than group oriented work arrangements, goal setting, performance evaluation and compensation. Countries where collectivism runs high the companies can assume that the individuals are not going to act recklessly and indulge in acts which return yields in the short run but is potentially dangerous in the long run.

Countries in which power distance is culturally accepted will have organisation structure which is centralised leading to centralisation of decision making authority and

less participation in decision making process. In low power distance countries organisations would have a decentralised structure leading to higher employees participation.

Culture and countries high in uncertainty avoidance would prefer to avoid, reduce risk and ambiguity. While designing control system for these culture and countries managers should put every thing in black and white. The systems should be elaborate and extensive. The performance standards should be clearly defined, formal and objective. Subjectivity in any manner should be avoided.

Local Institutions

Social, government and legal system vary significantly across nations. These institutions include government agencies, corporate ownership structure, banking system, labour unions, bargaining and grievances resolution mechanism, regulatory agencies, insurance companies etc.

Countries having strong labour unions and rigid labour laws, implementing any performance evaluation scheme, compensation scheme, voluntary retirement scheme, promotions etc. based on productivity will be met with strong resistance whereas it would be easier to implement in those countries where Labour laws are flexible and labour unions reasonable.

Another institution which plays important role in designing management control system are the financial markets including regulators. In some countries funds have to be raised from local markets or certain percent of equity had to be disinvested to the public. This requires disclosure and certain type of other information with the advent of FlI's in developing countries event short term accounting profits are reflected in share prices. This coupled with the threat of hostile takeover puts an constant pressure on managers of keep stock valuations high through high short term earnings. The rules and regulation regarding takeover differ from country to country. In USA it is usually easy to make an hostile takeover as compared to European countries. in developing countries the regulations regarding takeovers are still evolving.

Another area of difference is the accounting standards. The accounting standards of the countries differ, based on which the accounting statements are being prepared.

This leads to variations in profits viz. financial statements of the same company will show different profits when prepared under different accounting standards. This problem is being addressed by preparing financial statements as per the ‘GAAP' Generally Accepted Accounting Principles.

Difference in local Business environment: Variables of local business environment such as:

Risk and uncertainty Related factors

These type of risk arise from the government behaviour, example changes in tax rates both direct and indirect, ban on imports and exports, price fixation and use of various other methods under it's discretion. The basic objectives of such type of action is to channalise capital and labour to the priority areas as decided by the government, price control, exchange control etc. In general in nations where the government has snore powers (developing countries, countries opening up their economies) the business risk is high, but at the same time in case of developing countries the focus of thin governments is on economic development and these governments through various policy measures are trying to attract foreign capital and technology. In newly industrialised countries which are in developing stage the companies are relatively young and in learning phase and are not having a well developed management control systems. Apart from these

factors the following factors are also a source of risk and *poor* functioning of management control systems.

Inflation: In general the developing countries are characterised by high inflation as compared to developed countries which have very low inflation. High inflation in the host country can cause a company's assets to deteriorate significantly in value in a short period of time. High inflation effects the congruence of financial measurement system. In can lead to adoption of inflation accounting. It can also lead to use of flexible budgeting to shield managers from uncontrollable inflation risks and partial abandonment of financial measures of performance evaluation.

Labour availability and quality : The quality of labour in terms of skills and productivity is generally lower in developing countries, which may lead to centralisation of decision making. The focus of the management control system shift towards action control rather than result control. The above stated factors make it difficult to implement the basic internal control principle, separation of duties. In brief the employers characteristics vary across countries and this leads to the variation in behavioural response towards control systems.

Labour Mobility: Labour mobility vary across countries, in some countries the policy is life time employment whereas in some countries it may be hire and fire policy. Keeping in view the policy climate prevailing in the host country the management control system, performance evaluation system and reward and compensation plan •should be designed. Apart from this there are many sectors which are characterised by high mobility of the work force.

Activity 2

List the various risk and uncertainty factors which are prevalent in Indian business environment.

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13.4 TRANSFER PRICING

Transfer pricing of goods, services and technology represents one of the major differences between management control of domestic and overseas operations. In case. of multinationals apart from normal consideration of transfer prices several other consideration are important in deciding the transfer price. They are briefly discussed below

1. **Taxation**: Income tax rates vary among different countries. A transfer price system that results in saving of aggregate income is followed. Companies operating in countries having high income tax rates will transfer goods and services at cost price thus resulting in zero profit and consequently no taxes. Transfer price mechanism is designed in such a way that maximum amount of profit accrues to companies operating in low income tax countries.

2. **Government regulations**: Given a choice companies the companies are going to model transfer price in such a fashion which minimise taxable income in the countries with high income tax rates, however government and tax authorities are aware of these methods and had passed legislation to crub these types of practices.

3) **Tariffs:** High tariffs of the importing company will force the exporting company to set the transfer price at lower level to offset the incidence of high tariff but this will result in low profit for the importing company, and for the exporting company low price and consequently low tariff would result into higher profit and hence higher income tax. The net effect of these two factors has to be considered while calculating transfer price.

4) **Foreign Exchange controls**: Most of the developing countries exercise foreign exchange control in some way or the other. In some countries the profits are not fully repatriable, domestic currency is not convertible, foreign exchange cess to import certain commodities etc. In these circumstance lower transfer price allows the subsidiary companies to import larger quantities of these material.

5) **Fund Accumulation :** Due to political and economical risks the holding company may not wish to park much of it funds in the subsidiary company, through transfer price funds may be bought into or out of a particular country.

6) **Joint Ventures** In case of joint venture company the economic interest of the joint venture partner has to be kept in mid while setting the transfer prices, the transfer price should not be detrimental to the economic interests of the joint venture partner.

Table 13.1 shows the transfer price method used by a sample of multinational companies for their cross-border transfer of goods.

Table 13.1: Transfer Pricing Methods Used by Multinational Companies

Pricing Method	**Number of firms**		**Percent of total**	
Cost Base Methods				
Variable cost-actual or standard	2		1	
Full cost - actual	6		4	
Full cost - standard	I 1		7	
Variable cost plus markup	2		1	
Full cost (Actual or standard) plus Markup	44	65	28	41
Market Base Methods:				
Market price	41		26	
Market price less selling expenses	19		12	
Others	12	72	8	46
Negotiated price		20		13
		157		**100**

Source: Roger Y.W. Tang "Transfer Prices in the 1990's," Management Accounting, February-1992, p.24.

Activity 3

In the Indian context, list the variables effecting transfer pricing.

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13.4.1 Transfer Pricing for an affiliate of a Multi National Company

In the previous section we had seen that how the differences in economic variables between the host and home country effects the setting of the transfer price. In addition to the already stated variables two other factors are also of importance

1) Transfer price to an affiliate in a country that is facing high inflation may be set at a relatively higher level in order to offset the effects of devaluation *of* local currency resulting from relatively higher inflation as compared to the home country.

2) The companies which have set up new affiliates in the host country may set transfer price relatively low in order to capture market share and gain a competitive advantage over already established market players.

Since most of the multinational corporations are based in USA and Europe it would be worthwhile to examine the methods followed by these multinational companies based in USA and Europe. In USA section 482 of Internal Revenue Code (IRC) is followed and the same has been recommended by The Organisation for Economic Cooperation and Development (OECD) for European countries. Section 482 *of IRC* specifies three acceptable ways in which transfer price among affiliates may be determined. These three methods are as follows:

1) **Comparable uncontrolled price method or market price method** : Under this method the firm sets the transfer price among it affiliates to conform to market price of similar goods and services as determined in market transactions where at least one of the parties to transaction is not an affiliate of the parent company. The reference transaction should not be a distress sale that represents unrealistically low or marginal pricing. Comparability is based on the similarity of the circumstances underlying the transaction. An uncontrolled sale would be considered comparable if the differences are such that they can be reflected by an adjustment of the selling price. Circumstances that may affect the prices include quality, terms of sale, market level and the geographical area in which the produce, is sold but will exclude quantity discount, promotional allowances losses due to currency fluctuations and credit differentials. Comparable Transfer price under this method is

   Transfer price = Price paid in comparable uncontrolled sales ± Adjustments.

2) **The resale price method :** Under this method the firm estimate an appropriate transfer price for a product, if that product becomes an input to another transaction within a reasonable period of time. This final transaction has to be/an uncontrolled sale. The transfer price is arrived after the resale price is reduced by an appropriate market percentage based on uncontrolled sale by the same affiliate or by the other resalers selling similar property in comparable market. The market

percentage of competitors or industry averages can also be used, Transfer price under this method is as follows :

Transfer price = Applicable resale price- Appropriate markup ± Adjustments

Applicable resale price is the price at which property purchased in a controlled sale is resold by the buyer in an uncontrolled sale.

Appropriate markup = Applicable resale price x Appropriate markup percentage

Appropriate markup percentage = Percent of gross profit

3. **Cost-plus method :** Under this method the transfer price is based on cost of producing the product calculated as per the accounting standards. To the cost is added an appropriate gross profit expressed as a percentage of cost; this gross profit is based on similar uncontrolled sales mode by the seller, by other sellers or the rate prevalent in the industry. Transfer price under this method is computed as follows :

   Transfer price = cost + Appropriate Markup ± Adjustment Appropriate mark up = costs x Appropriate Gross profit percent

13.5 EXCHANGE RATE AND MANAGEMENT CONTROL

Exchange Rates ; An exchange rate is the price of one currency relative to the other currency. it can be either expressed as number of units of the home currency to buy another currency (direct. Quote) or the number of units of foreign currency to buy one unit of home currency (Indirect Quote), For e.g. if Indian rupee is the home currency and dollar is the foreign currency then to express Rs. 50/- $ is a direct quote and to express the same as .02$/- Rs is an indirect quote. The exchange rates that are usually quoted are nominal exchange rate. The spot exchange rates are nominal rates that prevail on particular point of time, whereas the real exchange rate is the spot exchange rate after adjusting for inflation differential between the two countries. There are also forward exchange rates which are exchange rates known to day at which transactions can be entered into for completion at some future fixed point of time. The forward rate may be at a discount or premium based upon the probable future inflation difference between two countries, also on the amount of trade deficits/surplus and host of other factors.

A currency is said to be appreciating if with the same unit of currency one can buy more units of foreign/reference currency as compared to previous time and a currency is said to be depreciating if the one unit of currency is able to buy less units of foreign reference time. For e.g. a year back 1 euro = Rs. 58.53 the rupee has depreciated against euro.

The difference between real and nominal exchange will become clear with the help of this example. Let us assume that a year back 1 $ = Rs. 50 and at present 1 $ = Rs. 55. The prevailing inflation rate during the year in USA was 5 percent and in India it was 10%. The purchasing Power Parity theory would predict that on the basis, of inflation differential the $ should have appreciated by 5% that is 1 $ = 52.5. At the spot rate of Rs. 55/$ the value of Rupee has depreciated 4.7% is the real depreciation in the value of the rupee against the dollar. After adjusting for the interest rate differential between USA and India the real exchange rate would be 1 $ = 52,35. The impact of the real

exchange rate changes create changes in cost competitiveness of the domestic manufacturers against its foreign competitors, In the above example this would imply.

that goods manufactured in India and priced in US $ have become 4.7% cheaper as compared to the same goods manufactured in US.

Activity 4

Find out the spot and forward exchange rate for Indian rupee against world's *major* currencies.

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Different Types of exchange Rate Exposure

In case of multinational organisations their cash flows are in different currencies and changes in value of the currency relative to the currency in which the holding company prepares it account exposes the multinational companies to various risks. These risks regarding exchange rate fluctuations are classified as

1) Translation Exposure

2) Transaction Exposure

3) Economic Exposure

1) **Translation Exposure** : This is the risk faced by MNC's when there are changes in nominal exchange rates. The cash flow of MNC's and it subsidiaries are in multiple currencies and when the accounts of MNC's are consolidated they must be in single currency usually home country's currency. In order to understand the translation exposure in MNC's one should try to answer this question. The cash flow of MNC's and its subsidiaries are in multiple currencies and there has been change in nominal exchange rate of these currencies with respect to the domestic currency, how do we consolidate revenue, expenses, liabilities and assets as on a given date or financial year closing date in a single currency.

2) **Transaction Exposure** is the exchange rate exposure that the firm faces in its cross border transaction. In this type of exposures the transaction are entered as of today but receipt or payment of consideration for the transaction is on future date. During this intervening period nominal exchange rate could change and put the value of transaction at risks. Example of these type of exposures are receivables and payables, debt and interest payments, insurance premium payable in foreign currency.

3) **Economic exposure** is the exchange rate exposure of the firm cash flow to the real exchange rate changes.

13.6 CONTROL SYSTEM DESIGN ISSUES

In view of the above stated exposures control system while evaluating performance should be responsive to the following facts :

1) Subsidiary managers should not be held responsible for translation effects as these factors are beyond their control. The way out is to compare budget and actual results using the same parameters and isolate inflation related effects through variance analysis.

2) Transaction exposure is best handled through the parent company keeping in view the overall hedging needs.

3) The subsidiary managers should be held responsible for the dependence effects of exchange rates resulting from economic exposures.

4) The decision to locate or relocate a subsidiary in a particular country should factor in the effects of translation, transaction and economic exposures.

13.7 SPECIAL CONTROL ISSUES IN MULTINATIONAL CORPORATIONS

Multinational corporations which own and operate business in multiple countries are important institution of trade and commerce. Multinational corporations are similar to large domestic organisations in the sense that in both of these organisation there is a high degree of separation of ownership and control and authority is delegated to large number of decision makers (managers) and control is exercised through financial results control.

Since managers of multinational corporations are trained on a large canvas they are better prepared to learn and apply potentially desirable practices used in foreign companies. An some of these practices have universal application across the countries, This is clearly demonstrated by the way in which US multinational organisation have adopted Just in Time (JIT) production methods, and target costing practices from Japanese corporations, similarly in Japanese corporation the traditional Japanese practices of compensation and promotion based on seniority is giving way to performance dependent reward systems.

Another peculiar situation faced by multinational organisation's manager is the existence of information asymmetry which prevails between managers at the headquarters and personnel in the foreign locations. The personnel based in the field have first hand knowledge about the operating environments which includes local norms, tastes, regulations and business risks. The prevalence of information asymmetry restricts the corporate manager from using action control as method of management control system. Action control are also more expensive to use due to geographical dispersion of the subsidiaries.

MNC's earn profit in multiple currencies and as a consequence bear a real economic risk caused by fluctuating currency value. The value of the foreign investment appreciate or depreciate based on the relative value of the home and foreign currencies.

Depending upon the performance evaluation practices used the subsidiary manager may be held responsible for bearing this risk or shielded from it.

Most MNC's evaluate the managers of foreign operations in terms of results measured in home country currency the underlying reason being

a) The home country currency is the unit of measure in which corporate financial objectives are stated.

b) It is the currency in which most of the shareholders would be investing and it is but natural that the returns expected by them would be in the home currency

c) It is the unit of measure used to evaluate top managers.

In view of the above it is but natural that the top managers encourages the subsidiary managers to take actions which result in increase of home currency denominated profit. However this approach would create problems in cowering performance based on average industry profit or rate of return norm.

In case the MNC's decide to evaluate the performance of subsidiary manager on the basis that he is not responsible for foreign exchange risk any of the following methods could be used.

1) Evaluate the manager in terms of local currency profits as compared to plans and budgets denominated in local currency.

2) Treat the foreign exchange gain or loss as "below" the income statement line for which the manager is accountable.

3) Evaluate the manager in terms of profit measured in home currency but at the same time calculate a foreign exchange variance and treat it as uncontrollable.

4) Convert the home currency budget for the subsidiary in local currency using the end of year, not beginning of year exchange rate. Through this process we are able to create a flexible budget which changes with the change in exchange rates.

13.8 SUMMARY

Multinational organisations play a important role in trade and commerce across the world MNC's whose operations spans across countries will have to adopt their management practice in order to factor in the diverse environments in which they operate. Similarly the transfer pricing policy will have to factor in the economic environment of the host country. The autonomy of setting the transfer price is restricted by various rules and regulations. MNC's have to pay due attention towards management of foreign exchange exposure and the management control system should take into consideration that managers.of the subsidiary should not be evaluated on the basis of uncontrollable factors. At the same time the top management should encourage the subsidiary managers to act in a way which maximises home currency denominated profits.

13.9 SELF ASSESSMENT QUESTIONS

1) How do cultural differences across nations alter the Management Control Systems?

2) Explain the reasons for manipulation of transfer price by the MNCs and their effects.

3) Which kind of foreign exchange exposures are controllable by a subsidiary manager.

4) Explain in detail the various methods of transfer pricing follower by MNCs.

5) "Control System Design should factor in various variables." Illustrate.

6) What are the various special control issues faced by MNCs.

7) What role does the local institutions play in designing of management control system of MNCs.

13.10 FURTHER READINGS

Geert Hofstede, Cultures Consequences: International differences in work related values, 3rd edition, Beverly Hills, California, Sage Publications 1986.

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